No. 12302

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CAPITAL SERVICE, INC., a Corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

OPENING BRIEF ON APPEAL.

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Jurisdictional Statement.

This appeal involves the Federal Income tax liability of the petitioner for the calendar and taxable year 1943. Respondent has determined that a deficiency in the amount of $7,358.10 exists for said year. The decision of the Tax Court of the United States sustained the determination of the respondent. The decision being appealed from was entered on May 12, 1949. The return of income tax, with respect to which this case has arisen, was filed by petitioner with the Collector of Internal Revenue for the Sixth Collection District of California, located in the City of Los Angeles, State of California. The case is brought to this Court by petition for review filed on June 15, 1949, pursuant to Section 1141 of the Internal Revenue Code (26 U. S. C. A., section 1141).

Statutes Involved in This Case.

Section 23, Internal Revenue Code. DEDUCTIONS FROM GROSS INCOME (26 U. S. C. A. Sec. 23):

> "In computing net income there shall be allowed as deductions:
>
> . . . (f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.
>
> . . . (k) *Bad Debts.* (1) *General Rule.* Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection."

Section 122, Internal Revenue Code. NET OPERATING LOSS DEDUCTION (26 U. S. C. A. Sec. 122):

> "(a) *Definition of Net Operating Loss.*—As used in this section, the term 'net operating loss' means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).
>
> (b) *Amount of Carry-back and Carry-over.* . . .
>
> . . . (2) *Net operating loss carry-over.* — If for any taxable year the taxpayer has a net operating

loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such intervening taxable year without regard to such net operating loss and without regard to any net operating loss carry-back. For the purposes of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1941 shall be reduced by the sum of the net income for each of the two preceding taxable years (computed for each such preceding taxable year with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6), and computed by determining the net operating loss deduction without regard to such net operating loss or to the net operating loss for the succeeding taxable year)."

Bank and Corporation Franchise Tax Act (California) (Deering's Gen. Laws, Act. 8488):

"Section 32. *Suspension and forfeiture of corporate powers.*

"(a) [Powers, rights and privileges of delinquent corporation to be suspended or forfeited.] If any tax, or any portion thereof, together with penalties, and interest thereon, which is due and payable either at the time the return is required to be filed or on or before the fifteenth day of the ninth month following the close of the income year, is not paid on or before six o'clock p.m. on the last day of the twelfth month after the close of the income year or if any tax due

and payable upon notice and demand from the commissioner, together with penalties and interest thereon, is not paid on or before six o'clock p.m. on the last day of the eleventh month following the due date of such tax, except in case of jeopardy or fraud assessments, in which case, if such tax, interest and penalties are not paid within 40 days from the date such tax, penalties and interest are due and payable (unless the bond required by this act is filed to stay the collection of such tax, penalties and interest and such tax, interest and penalties are paid within 60 days after notice by the commissioner on taxpayer's petition for reassessment), the corporate powers, rights and privileges of the delinquent taxpayer, if it be a domestic bank or corporation, shall be suspended and shall be incapable of being exercised for any purpose or in any manner except for the purpose of amending the articles of incorporation to set forth a new name; if the delinquent taxpayer be a foreign bank or corporation the right to exercise its corporate powers, rights and privileges in this State shall be forfeited. . . ."

Section 33. *Revivor of corporate powers: Corporate name: Transfer of records and funds:*

"Any bank or corporation which has suffered the suspension or forfeiture provided for in the preceding section may be relieved therefrom upon making application therefor in writing to the commissioner and upon payment of the tax and the interest and penalties for nonpayment of which the suspension or forfeiture occurred, together with all other taxes, deficiencies, interest and penalties due under the act, and upon the issuance by the commissioner of a certificate of revivor. Application for such certificate on behalf of any domestic bank or corporation which has suffered such suspension may be made by any

stockholder or creditor or by a majority of the surviving trustees or directors thereof; application for such certificate may be made by any foreign bank or corporation which has suffered such forfeiture or by any stockholder or creditor thereof . . ."

Statement of the Case.

Petitioner raises no question herein with respect to that portion of the opinion of the Tax Court in which it was held that petitioner is not entitled to carry over a 1941 net operating loss, a year for which petitioner filed a separate return, and deduct said loss in 1943, a year for which petitioner filed a consolidated return.

The sole question to be decided in this appeal is whether petitioner sustained in the calendar and taxable year 1942 a net operating loss, as defined in Section 122(a) of the Internal Revenue Code (26 U. S. C. A., section 122(a)), which may be carried over and used as a net operating loss deduction for the calendar and taxable year 1943, as provided for by Section 122(b)(2) of the Internal Revenue Code (26 U. S. C. A., section 122(b)(2)).

The determination of the question presented depends upon whether the indebtedness of $31,567.81 owed to petitioner by, and stock at an adjusted cost basis of $1,300 held by petitioner in, the Central California Utilities Corporation became worthless during the calendar and taxable year 1942, as contended by petitioner, thus permitting deductions to be made from the gross income of petitioner for the year 1942 under the provisions of Sections 23(k) and 23(f), respectively, of the Internal Revenue Code (26 U. S. C. A., Sections 23(k) and 23(f)), or prior to said calendar and taxable year, as contended by respondent.

The decision of the Tax Court of the United States, sustaining the determination of the respondent, is based upon a finding by the Tax Court that the debt owed to petitioner by and the stock held by petitioner in Central became worthless prior to 1942. It is the position of the petitioner that the Tax Court erred in sustaining the determination of the respondent in that:

(1) The decision of the Tax Court is not supported by any evidence; and

(2) The Tax Court, in making its decision, did not apply the correct principles of law.

Statement of Facts.

Central California Utilities Corporation, hereinafter referred to as Central, is a California corporation, formed on August 3, 1936, for the purpose of acquiring the assets and assuming the liabilities of the Inland Public Service Company, hereinafter referred to as Inland. Inland had owned since 1933 all of the issued and outstanding capital stock of the Gas Fuel Service Company and the Kettleman-Lakeview Oil and Gas Company, Ltd., both of which are California corporations, hereinafter referred to as Fuel and Kettleman, respectively. [Stip. of Facts, par. 5, Tr. p. 29.]

On August 28, 1933, the Railroad Commission of the State of California in Decision No. 26297 [Joint Ex. 2-B, Tr. 49] had granted to Fuel a Certificate of Public Convenience and Necessity authorizing it to distribute natural gas in the counties of Kings and Fresno, in the state of California, pursuant to ordinances passed by said counties.

The above mentioned decision of the Railroad Commission was supplemental to Decision No. 26178 of the Commission, dated July 21, 1933 [Joint Ex. 1-A, Tr. 32], in which the Commission had ordered [Tr. 47], over the opposition of the Coast Counties Gas and Electric Company, the West Side Natural Gas Company, and the Southern California Gas Company, that:

> ". . . public convenience and necessity require and will require the exercise by Gas Fuel Service Company of the rights and privileges granted to it under the franchises which it contemplates securing from the counties of Kings and Fresno, the construction and operation of the natural gas transmission and distribution systems and the service of natural gas under rates all as set forth in its amended Application No. 18672 . . ."

Coast Counties Gas and Electric Company and the West Side Natural Gas Company resisted Fuel's application because they were desirous themselves of obtaining the permission of the Railroad Commission to operate in the area set forth in Fuel's application. The Southern California Gas Company protested the granting of a certificate to Fuel, although it did not desire to serve agricultural power consumers in Fresno County, but was interested only in serving the Tulare Lake Bed area of Kings County. [Joint Ex. 1-A, Tr. 36-47.]

Evidence adduced in behalf of Fuel before the Railroad Commission indicated that the organizers of that company owned 1500 acres of potential gas and oil lands in the Dudley Ridge area of Kings county. These organizers, who were largely farmers, had three years earlier incorporated Kettleman for the purpose of developing their

properties. They had been able to bring in three wells on their properties, which produced approximately 20,000,000 cubic feet of natural gas daily. Of this amount of gas, only 1,000,000 cubic feet per day were sold under contract, this, in large part, going to the Pacific Gas and Electric Company. [Joint Ex. 1-A, Tr. 36-37.]

In order to dispose of the surplus gas, the land owners organized Fuel, and entered into a survey to determine the market for natural gas amongst the farmers of Kings and Fresno counties. At that time, most farmers were using electric power for irrigation pumping purposes. It was learned that the rates charged by the electric utility companies were so high as to render the use of electric power for irrigation pumping purposes economically unfeasible. [Joint Ex. 1-A, Tr. 37-38.]

Sensing the tremendous potential market which existed for the sale of natural gas for irrigation pumping purposes, Fuel applied to the Railroad Commission requesting that it issue its certificate that public convenience and necessity required Fuel to construct and operate a natural gas transmission and distribution system in Kings and Fresno counties. [Joint Ex. 1-A, Tr. 37.]

Fuel proposed to sell the gas for sixteen cents per thousand cubic feet in Kings county and for seventeen cents per thousand cubic feet in Fresno county; these rates were approximately eight cents lower than the rates proposed by the Coast Counties Gas and Electric Company and the West Side Natural Gas Company for service in the same area. Statistics were placed before the Railroad Commissioners by Fuel indicating that at the rates it had proposed, the farmer consumers of the gas would be able to satisfy

their irrigation pumping needs at a saving of from one-third to one-half of the amount previously paid by such consumers for electric power. [Joint Ex. No. 1-A, Tr. 38, 42-43.]

The franchises granted by the counties of Kings and Fresno in 1933 gave to Fuel the right to lay and maintain a gas distribution line within the territorial limits of each of the two counties. While the franchises thus granted were not exclusive, these franchises were in effect at all times material herein, and could have been exercised by Fuel at any time, so long as it held the certificate of public convenience and necessity. [Stip. of Facts, pars. 9 and 10, Tr. 30; Joint Ex. No. 3-C, Tr. 52; Joint Ex. No. 4-D, Tr. 56.]

After the granting of the certificate of public convenience and necessity, Fuel proceeded to lay approximately thirty-two miles of pipe line in Kings County, and began the distribution of gas. However, by the latter part of 1935, Inland and its two subsidiaries, Fuel and Kettleman, were in serious financial difficulty, and operations were discontinued. The three corporation system was in great need of working capital, current assets being valued at only $1,800, while current liabilities as of December 31, 1935 amounted to $60,000. Fixed assets were valued at the following figures: pipe lines $44,740.78; general office equipment, $463.98; meters, $354.56; and miscellaneous equipment, $407.55. Lands, leases, and wells had been valued at slightly in excess of $1,000,000, but as of December 31, 1935, these assets were abandoned, because of the lack of working capital, and because Kettleman's only remaining well had blown out, thus depriving Fuel,

the distributing corporation, of its gas supply. At the time of cessation of operations, Fuel was serving only ten or fifteen customers. [Tr. 283-285, 288-289.]

The promoters of the Inland system approached one Ralph Moore in the latter part of 1935, seeking his assistance in the procurement of financial aid for the system. [Tr. 86.] Moore proceeded to investigate the prospects for making Inland a profitable operation. He was impressed with the same factors that had originally inspired the formation of Fuel, and the acquisition by that company of the certificate of public convenience and necessity, already referred to: he found that in Kings and Fresno Counties, an exceptionally favorable market for natural gas products existed, and that in the vicinity of this market, ample supplies of gas could be obtained. [Tr. 87, 94-100.] Moore conferred with the heads of various farmers' organizations, and with various potential industrial users of natural gas, and, as a result of such discussions, concluded that the utility system could sell from twenty-five to thirty million cubic feet of gas per day, for about seven months out of the year, that is to say during the period when irrigation pumping was necessary. [Tr. 99.]

As to the matter of an immediate supply of natural gas, Moore discovered that an agreement could be made with the owner of three wells which had, in the past, produced large quantities of gas, which had been sold to the Pacific Gas & Electric Company; the latter company had stopped purchasing gas from these owners. [Tr. 96-97.] In addition to these three wells, there were many others which had had to cease operations when the Pacific Gas & Electric Company had stopped purchasing in the area in question, and Moore felt optimistic as to the prospects

for obtaining a supply of natural gas sufficient to satisfy the potential market which he had ascertained existed in the two counties. [Tr. 100.]

It was Moore's considered opinion that a large natural gas utility system in Fresno and Kings counties could be created through a reorganization of Inland. In arriving at this conclusion, Moore took into consideration the certicate of public convenience and necessity that had been granted by the state of California to Fuel, and which gave the company the legal right to distribute natural gas in Fresno and Kings counties; he also took into account the results of his investigations in the area, which had revealed a great potential market for natural gas, and the existence of an extensive supply of gas in the same oil-rich area. Moore realized, however, that to take advantage of the three factors, the certificate, the market, and the supply, a considerable amount of capital would be needed. [Tr. 88, 94.]

Moore approached the Los Angeles investment firm of G. Brashears & Company, for the purpose of planning a means of raising capital for the Inland system. [Tr. 88.] At that time, G. Brashears & Company was in the process of organizing petitioner for the purpose of making small amounts of capital available to certain speculative enterprises in return for a stock interest in such enterprises. The business purpose of petitioner was not merely to loan money at interest, but was to obtain stock in the corporations to which money was loaned, so that a speculative profit might be realized by petitioner in the sale of its stock interest if the assisted corporation became successful. [Tr. 318-319, 330.]

As a result of the negotiations between Moore and G. Brashears & Company, petitioner made loans totalling $39,611.71 to the Inland system, in conjunction with a plan of reorganization, as a result of which a new corporation, Central, acquired the assets and assumed the liabilities of Inland. The assets of Inland consisted only of stock in Fuel and Kettleman. [Joint Ex. No. 8-H, Tr. 73-75, 89.] The stock of Central was issued and distributed as follows: (a) 117,000 shares to the old Inland stockholders, one share of stock in Central being exchanged for three shares of stock in Inland; (b) 187,500 shares to petitioner, and (c) 62,500 shares to Ralph Moore. [Tr. 89-91.] The remaining authorized shares of Central were to be available for future sale. [Tr. 93.] Since 1936, petitioner has owned an additional 1,050 shares of stock in Central, which it carries at an adjusted cost basis of $1,300; these shares are the remainder of 1,500 shares of Central which were purchased from H. A. Savage in settlement of a claim held by the latter. Four hundred and fifty of the shares which had been purchased from Savage were delivered by petitioner to Henry K. Elder, attorney at law, in satisfaction of the latter's claim against Fuel and Kettleman for legal services rendered them. [Resp. Ex. K, Tr. 298-299.]

Because petitioner was not in existence at the outset of negotiations between Moore and G. Brashears & Company, Moore and G. Brashears & Company loaned $1,000 and $3,000, respectively, to Inland, and were repaid by petitioner soon after it obtained corporate existence on August 23, 1936. [Tr. 182.] At no time after this initial phase did G. Brashears & Company have direct dealings or relations with the Inland-Central system.

Prior to the reorganization of Inland, the system had ceased operating entirely. [Tr. 98-99.] The misconception never existed that the loan by petitioner of $39,611.71 would be a sufficient amount to develop the utility system which had been envisioned by Moore after his investigation and inspection of the project. The plan was to keep the certificate of public convenience and necessity possessed by Fuel alive until such time as the development of the utility system could be accomplished by public financing, or by the sale of the stock held by petitioner in Central to other interests which themselves would undertake the development of the utility system. [Tr. 232-234, 320.] Petitioner expected repayment of its loan and benefit from the stock held in Central only through the accomplishment of either of these objectives. [Tr. 232-234, 320.]

Testimony adduced in the trial court establishes that the stock of Central held by petitioner had no market value at the time the reorganization took place or at any time subsequent thereto, that the loan by petitioner to Central was purely speculative in nature, and that the physical assets of the utility system had little, if any, market value. [Tr. 218, 224, 232-234, 320; Joint Ex. No. 8-H, Tr. 75; Tr. 192-195, 233.] The value of the stock and the value of the note receivable by petitioner were of a potential nature only and this potential value could only mature into actual, realizable value if petitioner was successful in its effort to acquire capital with which the utility system could take full advantage of the certificate of public convenience and necessity possessed by Fuel, or, in the alternative, to sell the stock held by petitioner in Central to other interests which themselves would undertake the development of the utility system. [Tr. 232-234, 320.] The efforts of petitioner along these lines were continuous

from 1936 through the middle of 1942, as is amply revealed by the record.

The Central system was unsuccessful in bringing in producing wells upon the land leased through funds loaned by petitioner, but was able to obtain sufficient gas from a well known as Irma #1, which was located on adjoining land. [Tr. 101-102, 103-104.] It must be emphasized that service for so few customers was maintained solely for the purpose of keeping the certificate of public convenience and necessity possessed by Fuel in effect. [Tr. 234.]

Irma #1 was destroyed by blasting which occurred in conjunction with certain geophysical surveys being made in the area by the Shell Oil Company in May of 1937, and thereafter the Central system supplied its few customers with gas purchased from the Southern California Gas Company. [Tr. 104, 125-128.]

The distribution lines of fuel were second-hand when laid, and in extremely poor condition; moreover, the lines were in many places laid on the surface of the ground, and were thus exposed to the elements and other forms of damage. As a result of these conditions, the lines leaked so badly that only approximately 25% of the gas that had been purchased from the Southern California Gas Company was actually delivered to the customers of the Central system. [Tr. 128-129, 133.] In the fall of 1937, a flood, which further damaged the pipe line, occurred in the Tulare Lake district, in which the customers served by the Central system were located. [Tr. 133.] Thus, at the end of 1937, it was necessary to discontinue the limited operations in which the Central system was engaged.

The Central system accordingly applied for permission of the California Railroad Commission to temporarily discontinue service, stating as its ground the necessity for repairing the distribution lines. [Tr. 132; Joint Ex. No. 5-E, Tr. 63; Joint Ex. No. 6-F, Tr. 66.] The service was not thereafter re-instituted. After the flood conditions had subsided, petitioner was of the opinion that reinstatement of service to the few customers of the Central system would cost more than the benefits to be immediately derived therefrom would be worth; moreover, at that particular time, petitioner was interested in several other enterprises, which if not given immediate financial assistance, would have been lost. [Tr. 236-237, 323-327.] Since the only valuable asset of the Central system was the certificate of public convenience and necessity held by Fuel, and since, in petitioner's judgment, the certificate was not in danger of being rescinded by the Railroad Commission, in view of the fact that the Railroad Commission had given Fuel permission to temporarily discontinue service, petitioner allocated the limited funds at its disposal to the projects having the most pressing immediate need. [Tr. 323-327; Joint Ex. No. 6-F, Tr. 66.]

Beginning in 1938, Moore negotiated with the Pure Oil Company, the Fullerton Oil Company, the Superior Oil Company, and the Lincoln Petroleum Company, for the purpose of acquiring a supply of gas. [Tr. 109-111, 198.] Moore was specifically interested in an arrangement under the terms of which the Central system would

purchase gas, provided that the producing company or companies would lend Central the money with which to lay a new pipe line. [Tr. 109, 197-199.] Although there was no question as to the surplus gas possessed by or available to these various companies or their desire to sell at the price Moore offered, as the Southern California Gas Company was paying far less, no arrangement was consummated on the basis contemplated by Moore. [Tr. 111-112.]

During 1939 the physical assets of Kettleman and Fuel were disposed of. [Joint Ex. No. 8-H, Tr. 75, 192-194.] These assets were of little value when the reorganization of the Inland system was undertaken, as is borne out by the low price they brought on sale, and had never been looked upon by petitioner as an inducement for, or as security for, the loan and investment petitioner had made. [Tr. 236, 232-233; Joint Ex. No. 8-H, Tr. 75.] Petitioner considered that the only asset of real value possessed by the Central system was the certificate of convenience and necessity that had been issued to Fuel, and that certificate remained in full force and effect until October 6, 1942. [Tr. 320, 326; Joint Ex. No. 7-G, Tr. 71.]

On January 6, 1940, the corporate charters of Fuel, Kettleman and Central were suspended for non-payment of franchise taxes, and were not thereafter revived. [Resp. Ex. M, Tr. 372.] Petitioner, having a number of pressing demands on it for funds, decided that it would be a needless expense to pay such taxes on the corporations in

the Central system until operations were to be resumed, in view of the fact that at that time revivor could be accomplished by payment of the franchise taxes. [Tr. 236-237, 323-327.]

During the year 1941, petitioner carried on separate negotiations with Messrs. Raphael Dechter and Ben Dudley, looking toward a sale of petitioner's interest in the Central project to groups represented by Dechter and Dudley, respectively. Although no precise meeting of minds resulted from these negotiations, petitioner's expectation that a sale of its interest in Central could be consummated continued until the year 1942. [Tr. 165-177, 238-240; Pet. Ex. No. 28, Tr. 165; Pet. Ex. No. 29, Tr. 172.]

During the entire period between 1936 and 1942, three factors existed continuously which rendered the plan of petitioner for the development of the Central system possible of fulfillment: (1) the certificate of public convenience and necessity which gave Central, through its subsidiary, Fuel, the legal right to distribute and sell natural gas in Fresno and Kings counties; (2) the supply of natural gas in the area; (3) the potential market for that gas in Fresno and Kings counties. [Joint Ex. No. 1-A, Tr. 32; Joint Ex. No. 2-B, Tr. 49; Joint Ex. No. 7-G, Tr. 71; Tr. 111-112; Tr. 94-95, 99, 100.] The only element lacking was sufficient capital to take advantage of these three factors. [Tr. 88, 320.] The history of petitioner with respect to Central, between 1936 and 1942, is one of persistent effort to obtain capital in

the amounts necessary to fully develop the Central system, or, in the alternative, to sell profitably its interest to other entrepreneurs, who would themselves undertake the development of the utility system. [Tr. 320, 232.]

In 1942, the surplus gas supply that had existed prior to that year ceased to be available. This was a result of the nation's developing war effort, which had the twofold effect of increasing the demand for natural gas in the metropolitan, industrial areas of the state, and, at the same time, of taking large amounts of natural gas off the market entirely, pursuant to a repressuring program which returned millions of cubic feet of gas to the subterranean areas from which it came. [Tr. 350-351, 176-179.] Moreover, the impact of the war upon business conditions generally made it exceedingly difficult to obtain capital for a basically non-war enterprise which could not be converted to war use. [Tr. 322.]

These conditions led petitioner to conclude in 1942 that the venture should not be carried further, and that the speculation in which it had engaged had failed, resulting in the loss of the money that had been loaned to Central, and in the worthlessness of the stock held by petitioner in that company. [Tr. 322.] As a result of this conclusion, a letter was written in June of 1942 to the Railroad Commission of the State of California which resulted in the cancellation of the certificate of public convenience and necessity possessed by Fuel in October of the same year. [Pet. Ex. No. 37, Tr. 249; Joint Ex. No. 7-G, Tr. 71.]

ARGUMENT.

POINT I.

Preliminary Statement as to the Law Governing This Case.

A. The Question of When Stock or an Indebtedness Becomes Worthless Is a Question of Fact.

The question of when stock or an indebtedness becomes worthless is a question of *fact,* the determination with respect to which is reversible only if the finding of the lower court is not supported by substantial evidence. With respect to the factual nature of the question of when stock becomes worthless, see *San Joaquin Brick Co. v. Commissioner* (1942 U. S. C. A. 9th), 130 F. 2d 220, 225; *Boehm v. Commissioner* (1945), 326 U. S. 287, 292-293, 66 S. Ct. 120, 123-124. With respect to the factual nature of the question of when an indebtedness becomes worthless, see *Redman v. Commissioner* (1946 U. S. C. A. 1st), 155 F. 2d 319, 321; *Cittadini v. Commissioner* (1943 U. S. C. A. 4th), 139 F. 2d 29, 31; *Raffold v. Commissioner* (1946 U. S. C. A. 1st), 153 F. 2d 168, 171.

The plain language of Sections 23(e) and 23(f) of the Internal Revenue Code, and their counterparts in many preceding Revenue Acts, in speaking of losses "sustained during the taxable year," has made it abundantly clear that a loss incurred on the worthlessness of corporate stock, to be deductible under these sections, must have been sustained *in fact* during the taxable year. See *Boehm v. Commissioner, supra,* at 291-293, 66 S. Ct. 123-124.

B. The Test to Be Applied in the Determination of When Stock or an Indebtedness Becomes Worthless Is a Practical, Objective Test, Varying With the Circumstances of Each Case; the Taxpayer's Attitude and Conduct Are Not to Be Ignored.

In the *Boehm* case, it was contended by the taxpayer that a subjective rather than an objective test was to be employed in the determination of whether corporate stock became worthless during the taxable year, within the meaning of section 23(e) of the Internal Revenue Code. The Supreme Court of the United States rejected this contention, and referred to its own statement in *Lucas v. American Code Co.,* 289 U. S. 445, 449, 50 S. Ct. 202, 203, wherein the Court said:

> "no definite legal test is provided by the statute for the determination of the year in which the loss is to be deducted. The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal, test."

The Court further stated in the *Boehm* case, at 293, 66 S. Ct. 124:

> "The standard for determining the year for deduction of a loss is thus a flexible, practical one, varying according to the circumstances of each case. The taxpayer's attitude and conduct are not to be ignored, but to codify them as the decisive factor in every case is to surround the clear language of Section 23(e) and the Treasury interpretations with an atmosphere of unreality and to impose grave obstacles to efficient tax administration."

Prior to 1942, Section 23(k) of the Internal Revenue Code allowed a deduction for "debts ascertained to be worthless *and* charged off within the taxable year . . ." (Italics supplied.) The Court in the *Redman* case, *supra,* at 320, states:

> "The test of ascertainment of worthlessness under Section 23(k) before the 1942 amendment was deemed to be a subjective test rather than an objective one, that is, the taxpayer was entitled to charge off a bad debt in the year that he determined the obligation to him to be worthless. He was not compelled to take his deduction in the year that the debt *actually* had become worthless but in the year that the hypothetical 'resonable man' would consider the debt to be worthless."

Section 23(k)(1) of the Internal Revenue Code, as amended by Section 124(a) of the Revenue Act of 1942 allows a deduction from gross income for "debts which become worthless within the taxable year; . . ." Subsection (d) of this amendment renders it effective with respect to taxable years beginning after December 31, 1938. In this regard, the *Redman* case, *supra,* states, at 320:

> "By its amendment to Section 23(k), Congress has changed the standard for the determination of worthlessness by substituting for the subjective test of ascertainment of worthlessness, the objective test of *actual* worthlessness." (Italics supplied.)

To summarize, then, the courts have held that the question of when stock or an indebtedness becomes worthless, for the purposes of obtaining a deduction from gross income, is one of *fact,* and that in the determination of the year in which such worthlessness occurs, a practical, flexible test is employed, under which all the factors, including the subjective factor, of a given case are taken into consideration.

C. The Taxpayer in a Case of This Type Carries the Burden of Proving: (1) That the Stock or Debt Is Worthless; and (2) That the Stock or Debt Became Worthless in the Year in Which the Deduction From Gross' Income Is Taken.

The burden of proof which rests upon the taxpayer who appeals in a case of this type from the determination of the Commissioner of Internal Revenue, is clearly delineated in the case of *Dunbar v. Commissioner* (1941 U. S. C. A. 7th), 119 F. 2d 367, 368-369, which is cited with approval by the United States Court of Appeals for the Ninth Circuit in the *San Joaquin* case, *supra.* The *Dunbar* case states, in substance, that the taxpayer carries the burden of proving: (1) That the stock or debt is worthless, and (2) that the stock or debt became worthless in the year in which the deduction from gross income is taken. As an amplification of the second point, the Court in the *Dunbar* case stated that the taxpayer, in order to demonstrate worthlessness in the year in which the deduction is taken, must prove that the stock or debt had some *intrinsic* or *potential* value at the close of the preceding year.

D. The Determination of the Commissioner Is Presumptively Correct Only Until the Taxpayer Proceeds With Competent and Relevant Evidence in Support of His Position—Then the Issue Depends Wholly Upon the Evidence so Adduced and the Evidence to Be Adduced by the Commissioner.

With respect to the question of the presumption favoring the determination of the Commissioner, and the effect of such a presumption upon the burden of proof of the taxpayer in a case of this type, this Court in *Perry v. Commissioner* (1941 U. S. C. A. 9th), 120 F. 2d 123, 124, stated:

> "This finding [the determination of the Commissioner] is presumptively correct, that is, until the taxpayer proceeds with competent and relevant evidence to support his position, the determination of the Commissioner stands. When such evidence has been adduced the issue depends wholly upon the evidence so adduced, and the evidence to be adduced by the Commissioner. The Commissioner cannot rely upon his determination as evidence of its correctness either directly or as affecting the burden of proof."

This Court stated in the *San Joaquin* case at 225, with respect to the same point:

> "It has been pointed out that in claiming tax deductions the taxpayer must show clearly that he comes within the statute allowing such deduction. But once he presents competent and relevant evidence on every necessary element, the presumption of correctness of the Commissioner's determination is no longer existent and the outcome of the case depends upon the determination of the trial body after the consideration of the evidence brought before it by both sides. When the evidence on both sides has been

adduced, and the Board makes its finding of facts, then the sole question presented to the Court, so far as the facts are concerned, is whether or not the Board's findings are supported by the evidence.

"If the taxpayer fails to present substantial evidence on every point necessary to entitle him to the deductions claimed, this Court upon petition for review necessarily will hold against their allowance. In so doing, we are not considering proof nor are we weighing evidence."

POINT II.

Competent and Relevant Evidence Was Adduced Below Proving That the Stock and Debt of Central Had Potential Value on December 31, 1941, and That They Became Worthless in 1942; No Evidence Was Introduced Below Which Will Support the Finding of the Tax Court That the Stock Investment and Indebtedness Became Worthless Prior to January 1, 1942.

Aside from the joint exhibits of petitioner and respondent below, the *only* evidence introduced by respondent was the following: 1. A letter written to Ralph Moore on November 22, 1940, by an agent of the Bureau of Internal Revenue [Resp. Ex. I, Tr. 208]; 2. Moore's response thereto, dated December 2, 1940 [Resp. Ex. J, Tr. 210]; 3. A detailed audit of the books and records of Capital Service, Inc. as of April 30, 1940 [Resp. Ex. K, Tr. 293]; 4. An audit of the books and records of Capital Service, Inc. as of December 31, 1940, and supplementing the audit of April 30, 1940 [Resp. Ex. L, Tr. 310]; 5. The certificate of the Secretary of State of California, with respect to the franchise history of Cen-

tral, Fuel, and Kettleman [Resp. Ex. M, Tr. 372]; 6. The Income Tax Returns of Kettleman for 1936, 1938, 1939, and 1940 [Tr. 381]; 7. The Corporate Income and Excess Profits returns of Central for the years 1936 through 1940, inclusive [Tr. 381]; 8. The Corporate Income and Excess Profits Tax returns of Capital Service, Inc., for the years 1936 through 1943, inclusive [Tr. 381-382]; 9. The Corporate Income and Excess Profits Tax returns of Fuel for the years 1936 through 1940, inclusive. [Tr. 382-383.]

Petitioner will refer in the course of its argument, to this evidence, the evidence introduced by petitioner, and the effect of cross-examination of petitioner's witnesses by respondent's counsel.

A. The Fact That Petitioner Supplied Capital to Other Enterprises After It Had Ceased so Supplying Central Does Not Support the Finding of the Tax Court That the Stock and Indebtedness of Central Became Worthless Prior to January 1, 1942.

The Tax Court takes the position in its opinion that the fact that petitioner supplied capital to other enterprises in which it was interested, after it had ceased supplying Central with funds, is one of the facts which ". . . show that long prior to 1942, the promoters of Central had given up all real hope of continuing this venture." [Tr. 407-408.]

As was stated by the Supreme Court of the United States in the *Boehm* case, *supra*, in the determination of the question of when stock (and the same reasoning is applicable to debts) becomes worthless, the subjective factor, although not necessarily the decisive factor, is a

factor which is not to be ignored. For this reason it is important to indicate at this point that the above inference is not waranted by *any* of the evidence.

The testimony of petitioner's witnesses Woodard, and Brashears reveals that petitioner was interested in Timm Aircraft Corporation, and the Ful-Ton Truck Company, in addition to Central, and that small sums of money were loaned to Timm and Ful-Ton after January, 1938, when petitioner made its last loan to Central. [Tr. 236-237, 324.] However, no conclusions may logically be drawn from this particular fact, until *all* of the evidence adduced below on the point has been examined. The above named witnesses for petitioner gave uncontradicted testimony that: (1) Petitioner *never* had at its disposal funds in the amount that would have been necessary to develop a gas utility system on the scale contemplated by petitioner and Moore. [Tr. 232, 320, 325.] Petitioner invested some $30,000 in the Central system for the purposes of (a) placing that system in a position which would enable it to be publicly financed through a sale of the authorized but unissued shares of Central, or, in the alternative, in a position which would allow petitioner to sell its stock interest in Central to others, who would themselves develop the utility, and (b) carrying on a minimal operation, so that the certificate of public convenience and necessity, the only asset of any value owned by the Central system, would be kept in full force and effect. [Tr. 320, 232-233, 236.] (2) Petitioner's capital resources were decidedly limited, and thus petitioner could

not materially alter the status of Central; however, the small capital transfusions which petitioner was able to muster for Timm and Ful-Ton *saved those ventures from being lost entirely.* [Tr. 325.]

On cross-examination of Mr. G. Brashears, respondent's counsel asked questions with respect to the volume of business done by G. Brashears & Company in 1935, and the "financial condition" of that Company in 1940 and 1941, in an effort to demonstrate that that Company had sufficient funds with which to finance Central, but did not do so because of a lack of confidence in the prospects of the system. [Tr. 331-335.] Brashears refused to state such facts from memory but offered to obtain books and records which would reveal this information, and which could be brought before the Court within fifteen minutes' time. This offer was declined. [Tr. 333.] It is submitted that no inference arises from Brashears' refusal to testify from memory, with respect to matters which had occurred nearly a decade earlier, that G. Brashears & Company and petitioner were financially able to lend money to Central, but considered the project so unworthy that no additional loans would be made. Such an inference is contrary to the direct and uncontradicted testimony of Messrs. Brashears and Woodard. [Tr. 325-327, 232.] Moreover, it is to be noted that Brashears did not fail to *produce* evidence, which failure normally gives rise to an inference against the party asked to produce evidence at his disposal. See Wigmore, *Treatise on Evidence,* Section 285. On the contrary, Brashears *offered* to produce

the best evidence of the financial condition of G. Brashears & Company, its books and records, but this offer was refused by respondent's counsel. [Tr. 333.] See Wigmore, *op. cit. supra,* Section 1179. As a matter of pressing this point to a logical conclusion, the fact that respondent's counsel refused to accept Brashears' offer to obtain the best evidence of the financial condition of G. Brashears & Company, its books and records, which could have been brought before the court in short order, gives rise to an inference against respondent's position. Wigmore, *op. cit. supra,* Sections 285 and 2273.

In summary of this point, the position of the Tax Court that the fact that petitioner supplied capital to Timm and Ful-Ton, after it had ceased so supplying Central, justifies the conclusion that ". . . long prior to 1942, the promoters of Central had given up all hope of continuing the venture," is not supported by any evidence. The position of the Tax Court is contrary to the testimonial evidence of two witnesses for petitioner. The testimony of these witnesses was not contradicted by that of any other witness, nor was it impeached by cross-examination; moreover, the circumstances of the case do not justify an impeaching presumption against the credibility of these witnesses founded merely upon their relation to the petitioner. See *Hauss v. Lake Erie & W. R. Co.* (U. S. C. A. 5th), 105 Fed. 733, 735-736, the reasoning of which is approved by the Supreme Court of the United States in *Chesapeake & O. Ry. Co. v. Martin* (1931), 283 U. S. 209, 219, 51 S. Ct. 453, 457.

B. The Sale in 1939 of the Physical Assets of Kettleman and Fuel Is Not a Fact Which Supports the Finding of the Tax Court That the Stock and Indebtedness of Central Became Worthless Prior to January 1, 1942. The Only Asset of Real Value Possessed by the Central System Was the Certificate of Public Convenience and Necessity Possessed by Fuel; This Certificate Was in Full Force and Effect Until October 6, 1942.

In cases of this type, in which the question is the time when stock or an indebtedness becomes worthless, a determination must be made of the *identifiable event* which indicates that the value of the stock or indebtedness has been completely extinguished. See *Jones v. Commissioner* (1939 U. S. C. A. 9th), 103 F. 2d 681, 684, 685.

During 1939, the physical assets of Kettleman and Fuel, the wholly owned subsidiaries of Central, were disposed of. [Joint Ex. No. 8-H, Tr. 75; 192-194.] However, disposition of these assets cannot be regarded as the identifiable event indicating complete extinguishment of the value of the stock and debt of Central. The uncontradicted testimony of petitioner's witnesses, Ralph Moore, Woodard, and Brashears, clearly states that these assets had never been looked upon as an inducement for, or as security for, the loan and investment petitioner had made, as they were of little value when the reorganization of the Inland system was undertaken. [Tr. 101, 233, 236, 320.] The testimony of the above mentioned witnesses in this regard is corroborated by the low price the assets brought on sale. [Joint Ex. No. 8-H, Tr. 75, 192-194.]

Evidence adduced by petitioner below establishes that petitioner considered that the only asset of real value possessed by the Central system was the certificate of

convenience and necessity which had been issued to Fuel, and that certificate remained in full force and effect until October 6, 1942. [Tr. 320, 326; Joint Ex. No. 7-G, Tr. 71.]

The Tax Court does not discuss the valuation of the certificate of public convenience and necessity in specific terms in its opinion; however, the Tax Court makes the statement that: "The potential value which petitioner contends continued to exist until revocation of the certificate in October 1942 was nothing more than wishful thinking." [Tr. 408.] This statement, unmistakably the product of hindsight, is not supported by any evidence. It is petitioner's position that under the objective situation revealed in the record, the certificate was a potentially highly valuable asset, as valuable until 1942, as it had been in 1936, when it was the major factor which had induced petitioner to embark upon the project of revivifying the Inland system. The certificate represented the legal authority granted by the State of California to bring the source of gas and the users of the commodity together. [Joint Ex. No. 1-A, Tr. 32; Joint Ex. No. 2-B, Tr. 49.] It must be emphasized that: (1) Respondent at no place in the record attempted to deny the fact that a large potential market for natural gas existed in Fresno and Kings counties, and (2) large supplies of gas were available in these two counties throughout the time covered in this case.

Roy M. Bauer, who was qualified as an expert witness on the valuation of such certificates, stated on direct examination by counsel for petitioner that a corporation which held on January 1, 1942, a certificate of public convenience and necessity to distribute natural gas in

Fresno and Kings counties, and also had the possibility of raising funds, either through public or private financing, and had a source of gas supply, at prices enabling it to resell at a profit, and also a potential supply of customers in the area, was the possessor of an asset of potential value; it must also be pointed out that Bauer's expert opinion assumed that the corporation holding the certificate of public convenience and necessity had no employees, no physical assets or cash, and no office, and was actually in debt. [Tr. 340-344.] Respondent introduced no evidence which contradicted Bauer's testimony. Cross-examination did not weaken Bauer's opinion based on the above assumed facts, the existence of which facts is amply revealed in the record. [Tr. 354, 363.]

The practical value of the right granted in the form of the certificate of public convenience and necessity is not to be underestimated: From the positive point of view, gas could not be distributed in Fresno and Kings counties without the certificate [Tr. 344]; from the negative standpoint, no competing organization could have such a right unless it was able to satisfy the burden of proof required by the Railroad Commission: ". . . In all cases the burden is on the applicant to show public necessity, and if there is a substantial conflict in the evidence, it must be resolved against him. This is required in order that the commission may ascertain . . . that public necessity does actually exist." *Bay Cities Transportation Co. v. E. H. Warren et al.* (1925), 26 C. R. C. 131. 134. The Tax Court in overlooking the potential and prac-

tical value of such a right, takes a position that is not supported by any evidence, and is contrary to evidence introduced by petitioner which was uncontradicted and unimpeached.

Because the certificate of public convenience and necessity was ultimately never exercised, as a result of certain supervening factors, which will be discussed *post,* occurring as concomitants of the nation's war effort, there is no justification for the use of hindsight to negate the existence of value prior to the occurrence of such supervening factors; the use of hindsight in this situation is opposed to the rule laid down in the *Lucas* case, *supra,* wherein the United States Supreme Court held that a *practical* test was to be used in determining the year in which losses occur.

In summary of this point, then, it is the position of petitioner that the disposition in 1939 of the physical assets of Fuel and Kettleman, which assets were of negligible value, and which had never been looked upon as an inducement for, or security for, the loan and investment petitioner had made, is not an identifiable event which in any way indicates the extinguishment of the value of the stock and indebtedness of Central, and therefore the disposition of such assets does not support the decision of the Tax Court that the stock and indebtedness became worthless prior to January 1, 1942. Petitioner from the outset considered that the only asset of value possessed by the Inland-Central system was the certificate of convenience and necessity possessed by Fuel, and this asset was held until October 6, 1942.

C. The Suspension on January 6, 1940, of the Corporate Charters of Fuel, Kettleman, and Central Does Not Support the Finding of the Tax Court That the Stock and Indebtedness of Central Became Worthless Prior to January 1, 1942.

The Tax Court, in its opinion, recites the fact that on January 6, 1940, the corporate charters of Fuel, Kettleman, and Central were suspended and not thereafter revived as one of the facts which prove that: "Long prior to 1942 the promoters of Central had given up all real hope of continuing this venture." [Tr. 407-408.]

It is submitted that suspension of corporate powers does not logically support such a conclusion. Under the law of the state of California, when franchise taxes are not paid, the Secretary of State must *suspend* corporate powers until such time as payment is made—but, the existence of the corporation as such is not interfered with. [Resp. Ex. M, Tr. 372, and the Bank and Corporation Franchise Tax Act (Deering's Gen. Laws, Act 8488, Sec. 32).] A corporation is enabled to function with no restraint whatever upon payment of the delinquent taxes. (Deering's Gen. Laws, Act 8488, Sec. 33.) As stated *supra,* the testimony of witnesses for petitioner Woodard and Brashears clearly indicates that petitioner had pressing demands upon it for funds, and obviously it would have been a needless expense to pay current franchise taxes until operations were to be resumed. [Tr. 236-237, 323-327.]

Prior to the reorganization of the Inland system, the corporate powers of Kettleman and Fuel had been suspended for nonpayment of franchise taxes, and it is to be noted that such suspension, and the revivor which took place upon payment of the taxes, had no impeding effect

upon the later activities of these companies. [Resp. Ex. M, Tr. 373.] In the same fashion, the suspension of corporate powers imposed in January of 1940 could have been removed by payment of the franchise taxes due and owing, just prior to the resumption of operations.

It is unrealistic and impractical to construe the suspension of corporate powers as being an identifiable event indicating the extinguishment of the value of the stock and indebtedness, in view of the fact that the same factors which originally interested petitioner in the reorganization of the Inland system continued to exist after such suspension, and also in view of the fact that the legal effect of the suspension could have been completely remedied, as stated above.

D. The Letter Written to Ralph Moore on November 22, 1940, by an Agent of the Bureau of Internal Revenue, and Moore's Letter in Response Thereto Dated December 2, 1940, Do Not Support the Finding of the Tax Court That the Stock and Indebtedness of Central Became Worthless Prior to January 1, 1942.

The Tax Court, in arriving at the decision from which this appeal is taken, placed heavy reliance upon a letter written by Ralph Moore on December 2, 1940 [Resp. Ex. J, Tr. 210], in response to a letter of an agent of the Bureau of Internal Revenue requesting information with respect to the value of stock in Central [Resp. Ex. I, Tr. 208], in view of the fact that certain shareholders in Central had allegedly claimed that the stock became worthless in 1939. [Tr. 409.] Respondent also placed great importance upon this letter as it is one of the few pieces of evidence which might be placed in the balance as opposed to the case made by petitioner.

Technically, the letter of Moore was introduced by respondent's counsel as a means of impeaching the credibility of Moore; and, thus, the greatest effect the letter can have is to render the testimony of Moore valueless to petitioner. In the language of Wigmore, *op. cit. supra,* Section 902:

> ". . . It is sufficient to note here that, in effect and primarily, it [a contradictory statement made by the same person at another time] neutralizes the statement on the stand by showing that the witness cannot be correct in both statements and is as likely to be wrong in the latter as in the former, and furthermore that his certain error in this one respect indicates a possibility of error upon other points."

Let us examine Moore's letter to determine whether it actually impeaches his credibility, that is to say, to determine whether it recites information inconsistent with that elicited upon the witness stand.

Moore stated in his letter that the stock of Central became "practically worthless" in the early part of 1939. Moore did not state the sense in which he meant the statement—*i. e.,* he did not state whether he was speaking in terms of potential value, or market value, or liquidation value. It would be entirely consistent to maintain, as Moore did while on the witness stand, that the stock had a great potential value to petitioner until the year 1942, and to state, on the other hand, that the stock became "practically worthless" from the standpoint of market value or liquidating value, early in 1939; Moore in this fashion explained, on redirect examination, the seeming inconsistency between his statements on the stand, and his statement in the letter in question. [Tr. 215-226.]

This point is made clear in *Sterling Morton v. Commissioner* (1938), 38 B. T. A. 1270, wherein it was stated:

> "The ultimate value of stock and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through forseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. If the assets of the corporation exceed its liabilities, the stock has liquidating value. If its assets are less than its liabilities, but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has a potential value and can not be said to be worthless. . . ."

Moore quite properly asserted in the letter that the certificate of public convenience and necessity had only a "questionable value," such value being commensurate with the profit that might be earned through operations. Such a statement is far from revealing a sense of abandonment, and Moore's activities, which will be discussed *post,* with respect to the utility, after the letter was written, refute such a connotation.

In any event, Moore's letter could not be used by the Tax Court as proof of the value of the stock of Central, since Moore had not been qualified as an expert witness with respect to the question of the valuation of the stock. If Moore's expression: ". . . [the] stock became practically worthless in the early part of 1939" was used by the Tax Court as evidence of the worthlessness of such stock, then the decision of the Tax Court is to that extent, at least, based upon incompetent opinion evidence. See *Jones on Evidence,* Section 1314 *et seq.* Apparently, the Tax

Court so used Moore's letter, as the statement, unsupported by any other evidence, is made: "If the stock was practically worthless early in 1939, the indebtedness of Central to petitioner must also have been worthless."

Aside from the question of the *competency* of Moore's expression of opinion in the letter with respect to the value of the stock of Central, as evidence of the value of the stock, it is the majority rule that prior inconsistent statements of a witness are not to be treated as having any substantive or independent testimonial value. See Wigmore, *op. cit. supra,* Section 1018; *Southern R. Co. v. Gray* (1916), 241 U. S. 333, 36 S. Ct. 558; *Woody v. Utah etc. Co.* (1931 U. S. C. A. 10th), 54 F. 2d 220; *New York Life Ins. Co. v. Bacalis* (1938 U. S. C. A. 5th), 94 F. 2d 200; *Ellis v. U. S.* (1943 U. S. C. A. 8th), 138 F. 2d 612; *Rex. v. Ledrew* (1945), 1 D. L. R. 453.

The rationale of this rule is based upon the fact that if the out of court declaration made by the witness, which is inconsistent with statements made on the witness stand, and which is introduced to impeach the witness, were used to prove the truth of the matter asserted therein, the hearsay rule would be violated. Wigmore, in Section 1018(a), states the proposition as follows:

> "a) Since . . . it is 'the repugnancy of his evidence' that discredits him, (the witness) obviously the Prior Self-Contradiction is not used *assertively; i. e.* we are not asked to believe his prior statement as testimony, and we do not have to choose between the two (as we do choose in the case of ordinary Contradictions by other witnesses). We simply set the two against each other, perceive that both cannot be correct, and immediately conclude that he has erred in one or the other,—but without determining which

one. It is the repugnancy and inconsistency that demonstrates his error, and not the superior credibility of the prior statement. Thus we do not necessarily accept his former statement as replacing his present one; the one merely neutralizes the other as a trustworthy one.

"In short, the *prior statement is not primarily hearsay,* because it is not offered assertively, *i. e.* not testimonially. The Hearsay Rule simply forbids the use of extra-judicial utterances as credible testimonial assertions to be relied upon. It follows, therefore, that the use of Prior Self-Contradictions to discredit is not obnoxious to the Hearsay Rule."

E. There Is No Evidence to Support the Finding of the Tax Court That All Negotiations for Disposition of the Certificate Had Failed by the End of 1940, and That the Negotiations in 1941 Were Nothing More Than "Feelers."

The Court below in its opinion expressed the view that by the end of 1940:

> "all negotiations for disposition of the certificate [held by Fuel] had failed. The so-called negotiations in 1941 were nothing more than feelers to see if any interest could be aroused." [Tr. 408.]

This conclusion is completely unsupported by the evidence, and is contrary to evidence adduced by petitioner which is uncontradicted and unimpeached. [Pet. Ex. No. 28, Tr. 165; Pet. Ex. No. 29, Tr. 172; Tr. 164-165, 170-172, 173-177, 238-240.] The negotiations carried on by Ralph Moore with Dechter and Dudley are evidence that the Central project attracted serious financial interest and that consequently, there were reasonable expectations of either raising the capital needed, or of petitioner's

selling out its position to other interests which themselves would seek to develop the project. The hindsight fact that neither Dechter nor Dudley followed through with his negotiations does not indicate that these expectations had disappeared. On the contrary, they continued to exist so long as the circumstances of the project and the general economic conditions remained unchanged, which they did, until the year 1942. [Tr. 322, 329, 350-351.]

F. No Evidence Was Introduced in the Tax Court From Which It May Be Concluded That Petitioner Postponed Taking Its Deduction for Losses on the Stock and Indebtedness of Central Until 1942, in Order to Obtain an Unlawful Tax Advantage.

The trend of the cross-examination by respondent's counsel indicates that respondent seeks to infer that petitioner postponed taking its deduction for losses on the stock and indebtedness of Central until 1942, in order to obtain an unlawful tax advantage. [Tr. 226-228.] It is to be noted, however, that the consolidated income for 1942 ($5,685.22 for the Bakery and $1,271.30 for petitioner), as determined by respondent, would have been more than completely eliminated by carrying forward net operating losses which respondent has stipulated existed for 1940 ($17,846.84 for the Bakery and $7,082.40 for petitioner) and 1941 ($8,681.99 for the Bakery and $2,752.49 for petitioner). [Stip. of Facts par. 2, Tr. 28.]

No evidence was introduced by respondent from which it may be concluded that petitioner expected large income for the years 1943 and 1944, as an off-set against which it desired a net operating loss carry-over arising out of the year 1942.

POINT III.

The Tax Court, in Making Its Decision, Did Not Apply the Correct Principles of Law.

There are certain principles of law, applicable to all cases involving the question of stock or debt worthlessness, that were disregarded by the Court below.

A. The Tax Court Did Not Correctly Apply Sections 23 (f) and (k) of the Internal Revenue Code.

The Court below in its opinion makes the statement: "If the stock was practically worthless early in 1939 the indebtedness of Central to petitioner must have also been worthless." [Tr. 409.] This statement reveals a loss of sight of the fact that deductions for worthlessness of stock and debts are not permitted under the provisions of the Internal Revenue Code unless the stock and debt are *entirely* worthless, in both the intrinsic and potential senses—that an asset is "practically worthless" is not enough. See Sections 23 (f) and (k) of the Internal Revenue Code (26 U. S. C. A., Sections 23 (f) and (k)), and *Boehm v. Commissioner, supra.*

Furthermore, the statement of the Tax Court that: "If the stock was practically worthless early in 1939 the indebtedness of Central to petitioner must have also been worthless," leads to the erroneous conclusion that the indebtedness was worthless to a greater degree than the stock. In order for the indebtedness to have become worthless, the stock must, of necessity, have first become worthless, not merely "practically worthless," as, under a fundamental principle of the law of corporations, creditors have priority over stockholders.

The Court also said:

> "Certainly by the end of 1940, petitioner had nothing upon which to rely except the faint hope that some financial 'angel' would purchase the certificate for at least $32,867.81 ($31,567.81 plus $1,300)." [Tr. 409.]

This statement is not only not supported by any evidence, but is also indicative of the same misconception as to the law with respect to worthlessness deductions for stock and bad debts under the provisions of the Internal Revenue Code. As has been indicated, *supra,* such deductions can only be made when the stock or debt in question becomes completely devoid of all value, both intrinsic and potential. The fact that by the end of 1940, a purchaser could not be found who would pay $32,867.81 for the certificate is an irrelevant consideration since we are concerned in this case with the sole question of when complete and entire worthlessness occurred.

B. The Tax Court, in Making Findings of Fact Upon Which the Decision Is Based, Incorrectly Resorted to Hindsight Judgment, Instead of Applying the Practical, Flexible Test Required by the United States Supreme Court in Boehm v. Commissioner.

The opinion of the Tax Court reveals that the Court, in making findings of fact upon which the decision is based, was influenced by the hindsight consideration that petitioner's plan for the development of the Central system never actually materialized. The Court stated in its opinion:

> "The potential value which petitioner contends continued to exist until revocation of the certificate in October, 1942 was nothing more than wishful thinking." [Tr. 408.]

Again the statement, already quoted, is made:

> "Certainly by the end of 1940 petitioner had nothing upon which to rely except the faint hope that some financial 'angel' would purchase the certificate for at least $32,867.81 ($31,567.81 plus $1,300)."

These statements are not supported by any evidence, and are unmistakably born of the wisdom possessed by all with respect to events long past.

The Supreme Court of the United States stated in the *Boehm* case, *supra,* that a practical, flexible, objective test was to be applied in the determination of when stock (and the same reasoning applies with respect to debts) becomes worthless. The Supreme Court also stated that the taxpayer's judgment is not to be ignored in cases of this type.

In the instant case, the Tax Court completely disregarded the evidence adduced by petitioner with respect to the practical, objective situation, and with respect to the subjective confidence of petitioner in the Central project until the year 1942; this evidence was neither contradicted by evidence adduced by respondent, nor impeached by respondent. [Tr. 320-322, 340-344.]

It is thus impossible to conclude that the Court below applied, in making its decision, the test laid down by the United States Supreme Court.

Moreover, the Tax Court itself in the case of *E. C. Olsen v. Commissioner* (1948), 10 T. C. 458, which is practically identical in factual situation to the instant case, and which will be discussed more fully *post,* has rejected the use of hindsight judgment.

C. The Tax Court, in Making Its Decision, Failed to Apply the Correct Principles of Law, as Revealed by Case Authority Binding Upon the Tax Court.

Let us first consider *Miami Beach Bay Shore Co. v. Commissioner* (1943 U. S. C. A. 5th), 136 F. 2d 408. There, the issue was whether stock owned by the taxpayer became worthless in 1937, as the taxpayer contended, or in 1936 as the Commissioner claimed. The taxpayer had proved by "every person having practical knowledge of and connection with the company," that from 1936 when a petition was filed for reorganization under the provisions of the Bankruptcy Act, until 1937, when the stockholders by their resolution brought an end to all prospects of reorganization, there was the possibility of putting the corporation back on its feet. The Court said, at page 409:

> "If the question for determination were whether the stock had, prior to the taxable year, lost the greater part of its value, we should readily agree with the Board. But that is not the question. As long as the stock has any value, either present or potential, the taxpayer may not claim a deduction on account of its value shrinkage. By the same token, the government may not deprive the taxpayer of its right to make the claim when the last vestige of value has disappeared."

The Court further said at 409-410:

> "This presumption which attended the Commissioner's finding here was, however, not a permanent but a temporary presumption which disappeared in the light of controlling and undisputed fact that throughout 1936 and until the middle of the fiscal year 1937, when the stockholders by this resolution brought to an end all prospects of reorganization,

Again the statement, already quoted, is made:

> "Certainly by the end of 1940 petitioner had nothing upon which to rely except the faint hope that some financial 'angel' would purchase the certificate for at least $32,867.81 ($31,567.81 plus $1,300)."

These statements are not supported by any evidence, and are unmistakably born of the wisdom possessed by all with respect to events long past.

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In the instant case, the Tax Court completely disregarded the evidence adduced by petitioner with respect to the practical, objective situation, and with respect to the subjective confidence of petitioner in the Central project until the year 1942; this evidence was neither contradicted by evidence adduced by respondent, nor impeached by respondent. [Tr. 320-322, 340-344.]

It is thus impossible to conclude that the Court below applied, in making its decision, the test laid down by the United States Supreme Court.

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> "If the question for determination were whether the stock had, prior to the taxable year, lost the greater part of its value, we should readily agree with the Board. But that is not the question. As long as the stock has any value, either present or potential, the taxpayer may not claim a deduction on account of its value shrinkage. By the same token, the government may not deprive the taxpayer of its right to make the claim when the last vestige of value has disappeared."

The Court further said at 409-410:

> "This presumption which attended the Commissioner's finding here was, however, not a permanent but a temporary presumption which disappeared in the light of controlling and undisputed fact that throughout 1936 and until the middle of the fiscal year 1937, when the stockholders by this resolution brought to an end all prospects of reorganization,

Again the statement, already quoted, is made:

> "Certainly by the end of 1940 petitioner had nothing upon which to rely except the faint hope that some financial 'angel' would purchase the certificate for at least $32,867.81 ($31,567.81 plus $1,300)."

These statements are not supported by any evidence, and are unmistakably born of the wisdom possessed by all with respect to events long past.

The Supreme Court of the United States stated in the *Boehm* case, *supra,* that a practical, flexible, objective test was to be applied in the determination of when stock (and the same reasoning applies with respect to debts) becomes worthless. The Supreme Court also stated that the taxpayer's judgment is not to be ignored in cases of this type.

In the instant case, the Tax Court completely disregarded the evidence adduced by petitioner with respect to the practical, objective situation, and with respect to the subjective confidence of petitioner in the Central project until the year 1942; this evidence was neither contradicted by evidence adduced by respondent, nor impeached by respondent. [Tr. 320-322, 340-344.]

It is thus impossible to conclude that the Court below applied, in making its decision, the test laid down by the United States Supreme Court.

Moreover, the Tax Court itself in the case of *E. C. Olsen v. Commissioner* (1948), 10 T. C. 458, which is practically identical in factual situation to the instant case, and which will be discussed more fully *post,* has rejected the use of hindsight judgment.

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there still was life in the company, there still was value, though potential only, in its stock. Congress in conferring the deduction in the general terms of Section 23 (f), and the Treasury in its Regulation 94, Revenue Act of 1936 did not set up a mere catch penny contrivance to be operated like a snare. It was expected that the loss thus allowed would be arrived at practically and by common sense methods, not by methods which break the promise to the hope while they keep it to the ear, and the courts and the Board have usually come up to that expectation." (The Court cited, among other cases, *Lucas v. American Code Co., supra.*)

In *Eaton v. Commissioner* (1944 U. S. C. A. 5th), 143 F. 2d 876, the Commissioner had disallowed a deduction based upon worthlessness of stock. The corporation involved was *not* a going concern; however, it owned physical assets which witnesses had testified were worth considerable value. The Tax Court, however, had held in the face of this evidence that the liabilities of the corporation exceeded the value of its assets, and upheld the determination of the Commissioner. The Court reversed the Tax Court, and said, at page 877:

"We cannot say that the finding of the Tax Court that before 1937 it had become apparent that the company would not be revived is without support in the evidence. We think it quite clear, however, that this finding is not at all determinative of the question at issue here as to when the stock became worthless.

"For while the company was without value as a going concern, it did have assets of considerable value, and every witness who appraised them valued them in excess of the indebtedness. . . . As

we pointed out in the *Miami Beach case, supra,* the question for determination is not whether the stock had prior to the tax year lost the greater part of its value. As long as it has any value, either present or potential, the taxpayer may not claim a deduction on account of its value shrinkage. By the same token, the government may not deprive the taxpayer of its right to make the claim in the year when the last vestige of value has disappeared. Here until the bank refused to renew, remanded payment of its debt, and under the threat of foreclosure secured a conveyance of the property, there was not only hope, there was prospect that the company, and therefore, the stockholders, would realize something out of its physical properties. . . . If in 1936 or in any earlier year, the taxpayers had attempted to claim a deduction as for total loss of value of this stock, the commissioner could very properly have denied it on the ground that as long as the bank was carrying and renewing the mortgage, and not pressing foreclosure, the physical properties being what they were, no identifiable event had occurred marking the stock a total loss. When the taxpayer confronted at last with a firm demand for foreclosure, determined to give up the fight and surrender the property, then, but not until then, occurred the identifiable event on which a claim for loss could be based."

In *Nelson v. U. S.* (1942 U. S. C. A. 8th), 131 F. 2d 301, 302, the Court said:

"The question [of stock worthlessness] is one of fact controlled by the evidence in this particular case. But certain principles applicable to all cases of this character may be adduced from the authori-

ties. . . . In the case of loss claimed because of the worthlessness of common stock of a corporation, actual worthlessness is the test. That the shares of stock may be worthless on liquidation is not decisive of the question. That common stock of a corporation has no value when its assets, fairly appraised are less than its liabilities unless, in such case, there is a prospect of improved conditions which will bring about the reverse. In the circumstances last mentioned, the stock has potential value and no loss for income tax purposes is realized by the owner until that potential value has disappeared. . . .

". . . Generally a taxpayer must prove some identifiable event which determines the time of actual loss. 'This may be a single event or a series; and occurs usually when the property in question is sold or disposed of or its value otherwise extinguished.' . . . (citing *Jones v. Commissioner, supra,* at 684).

"It has been said that this burden of proof is a difficult one at best and that the taxpayer should not be held to hard and fast technical rules in determining the precise time in which the loss occurred." (Citing *Dunbar v. Commissioner* (1941 U. S. C. A. 7th), 119 F. 2d 367, 370.)

In concluding its opening brief, petitioner desires to call the attention of this Honorable Court to *E. C. Olson v. Commissioner* (1948), 10 T. C. 458, wherein, in a factual situation practically identical to that involved in the instant case, the Tax Court, in applying the foregoing principles of law, reached a decision completely *contra* to that arrived at by the Court in the instant case. In the *Olson* case, the Tax Court had to decide, among other things, whether: (1) The Commissioner erred in determining that the stock of the taxpayer in the Trask-

Willamette Company became worthless prior to 1941, and (2) Whether the Commissioner erred in disallowing a bad debt deduction in connection with a Trask-Willamette note.

The taxpayer was an individual; in 1935 taxpayer had been instrumental in incorporating the Trask-Willamette Company, for the purpose of logging on a certain tract in Oregon containing fire-damaged timber. The taxpayer purchased 250 shares of stock in the corporation, at $100 per share. Much of the equipment owned by the corporation was under chattel mortgage to the Bank of California. The only other asset of the corporation was the contract giving it the right to log on the aforementioned tract; the contract covered a billion feet of timber at a good price.

Early operations of the company resulted in a deficit prior to 1939. In 1939, a second fire attacked the tract covered by the contract possessed by the corporation, which fire destroyed a number of the railroad bridges on the only railroad serving the tract. Much of the mortgaged equipment was destroyed in the fire; in 1940, the Bank of California brought foreclosure proceedings, and purchased the mortgaged property at the foreclosure sale; a deficiency of $24,000 remained after the sale.

It is to be noted that resumption of logging would have required additional capital with which to procure equipment, and to rebuild the railroad or obtain trucks in its stead.

At the end of 1940, the only asset held by the corporation was its timber contract.

During 1941, all prospects of repairing the railroad or of procuring trucks vanished, and the taxpayer claimed

a loss on his stock in the company, contending that it had become wholly worthless in 1941.

In 1935, the taxpayer had loaned $25,000 to the corporation, and had received a note secured by a chattel mortgage on certain logging equipment. The unpaid balance on the note in 1941 was $8,969.30, and the taxpayer took a bad debt deduction in that year. As a result of the activity of the lumber industry during the war and immediately afterward, the amount unpaid on the note was met in 1946.

The Commissioner of Internal Revenue had disallowed both deductions taken in 1941.

The taxpayer testified in the Tax Court proceeding that even after the 1939 fire and the 1940 sale of the equipment, he still was of the opinion that the Trask-Willamette lumbering rights under the contract were of such profitable character, that he considered the possibility of obtaining capital with which to construct a road by means of which the timber could be removed from the tract by truck. Efforts were also being made to finance the railroad, and these efforts were not given up until 1941.

According to evidence introduced, the taxpayer was an outstanding business man, whose reputation indicated that he was possessed of sound judgment.

The Tax Court held, reversing the determination of the Commissioner, that the stock and debt of Trask-Willamette had prospective value on January 1, 1941, although obviously of only potential nature, and that

within the limits of reasonable judgment, based upon facts available to the taxpayer in 1941, and prior to his filing his income tax return for that year, both items became worthless during 1941. As already mentioned, *supra,* the Tax Court in this case disparaged the use of hindsight valuations.

The factual situations involved in the *Olson* case and in the instant case are practically identical. In both cases, an intangible right was the only asset owned by the corporation in which the taxpayer was interested, *i. e.,* in the *Olson* case, the only asset owned by Trask-Willamette after the 1939 fire, and the foreclosure proceedings in 1940, was the contract giving the corporation the right to lumber on a certain tract of land, while in the instant case, the only asset of the Central system, after the sale of the inconsequential physical assets of Fuel and Kettleman in 1939, was the certificate of public convenience of necessity held by Fuel, which asset was in full force and effect until 1942. In both cases, the only factor necessary to make use of the intangible rights held was that of a sufficient amount of capital. In both cases, if the capital had been obtained, there is no doubt that the stock and debt held by the taxpayers in each of the two cases would have been highly valuable assets.

In summary of this point, had the Tax Court applied, in making its decision, the correct principles of law, as revealed by the *Olson* case, and the other cases cited herein, it is clear that it could not have sustained the determination of the respondent.

Conclusion.

It is the position of petitioner that the stock and debt of Central had potential value in a practical, objective sense until 1942. During that year, as a direct result of the nation's war effort, the surplus gas which had been available in Fresno and Kings counties at all times herein mentioned, was taken for other uses. [Tr. 176-177, 350-351.] A tremendous quantity of gas was taken off the market entirely pursuant to a Federal repressuring program which had the purpose of enabling more oil to be pumped from the ground. [Tr. 350.] The gas that was not returned to the ground in accordance with this program, was in large part piped to Los Angeles and San Francisco, for use in war industry located in those two areas. [Tr. 176-178.] Moreover, the impact of the war upon general business conditions made it practically impossible to obtain capital for a basically non-war enterprise, such as that involved in the instant case, which could not be converted to war use. [Tr. 322, 329.] At this point, petitioner concluded that it would be impossible to realize upon its speculation. [Tr. 322, 329, 351-352.]

It is the contention of petitioner that the disappearance of the surplus gas, which was one of the key factors upon which the Central project had been based, the practical impossibility of raising capital for such a project, and the consequent letter of June 9, 1942, resulting in the revocation by the Railroad Commission of the certificate of public convenience and necessity held by Fuel, are the identifiable events which indicated that the value of the stock and indebtedness had been *completely extinguished,* and that until these events occurred, the Central project possessed a *potential* value which would not have permitted the

writing off of the above mentioned stock and indebtedness, under the provisions of Sections 23 (f) and (k) of the Internal Revenue Code (26 U. S. C. A., Secs. 23 (f) and (k)). [Pet. Ex. No. 37, Tr. 249; Joint Ex. No. 7-G, Tr. 71.]

The decision of the Tax Court, sustaining the determination of respondent that a deficiency in income tax in the amount of $7,358.10 is owing by petitioner for the calendar and taxable year 1943, is erroneous in that: (1) The decision of the Tax Court is not supported by any evidence; and (2) The Tax Court, in making its decision, did not apply the correct principles of law. For these reasons, it is respectfully submitted, the decision of the Tax Court ought to be reversed and set aside.

Respectfully submitted,

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